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The effects of the National Debt on the United States as a Superpower

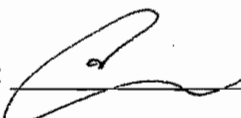
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PREFACE AND ACKNOWLEDGEMENTS

Although my past degrees did not focus on economics, one of my passions is finances. Throughout my lifetime, I always wanted to learn how the U.S. financial system operated. While at Marine Corps Systems Command as a project officer from 2004-2007, I spent \$400 million of government funds and learned the basics of the federal budget. However, I still did not quite grasp the goal of expenditures and revenues balancing out to avoid major debt issues. After numerous hours of research and studying to understand financial terms, government programs, and federal economic direction, this thesis opened my eyes to how the biggest financial system in the world operates. Despite the country's current financial problems, I truly believe that the United States remains a superpower and world leader well into the future.

To my wife, Tanya, and our beautiful girls, Victoria and Isabella: your encouragement and patience while writing this thesis is very much appreciated. Tanya, thank you for all your help with editing and for the constructive feedback.

EXECUTIVE SUMMARY

Title: The effects of the National Debt on the United States as a Superpower

Thesis: This paper outlines how the United States remains a superpower despite the country's federal debt situation.

Discussion: Outlays, receipts, budget deficit, federal debt, gross domestic product (GDP), discretionary and mandatory spending, interest spending, trade deficit, and the definition of superpower are all covered in detail. The actions of the government during the recent recession (2008-2009) are expounded upon, and reasons are provided to support the thesis that the country's financial condition allows the U.S. to remain an economic superpower. One of the more important economic factors to maintain global economic superiority is the trade deficit. Increasing exports are a major factor in improving job growth and ultimately boosting the U.S. economy. Since the financial debt is such a controversial subject among lawmakers and economists, the decline of the U.S. as an economic superpower is looked at from different angles. Comparisons between the U.S. as a great power and past European empires are made to show the correlation and potential signs of collapse. In addition, other country's financial situations are compared to the U.S. to illustrate how interest outlays on federal debt impact a country's ability to pay its debt. The country's current financial health requires reduced discretionary spending which leads to a stagnant defense budget. This affects the military's response to worldwide crisis and causes several military programs and personnel to be reduced or cut. In order for the U.S. to remain a superpower, shielding the military from massive spending reductions is necessary.

Conclusion: The hard power capabilities of the U.S., economics and military, are essential for the U.S. to remain a superpower. The country's soft powers, such as diplomacy and cultural influence, are also critical but these are not covered in this thesis. As the country comes out of the recession and the economy begins to grow again, spending needs to be reined in. The Administration and Congress are currently negotiating reduced spending for the 2012 federal budget and immediate years thereafter. Next, the country needs to keep interest outlays below 2% of GDP and revenue intake around the historical normal of 18% of GDP. Tax breaks put into law in 2010 put more money in taxpayer's pockets, and the Administration is relying upon these tax breaks to spur economic growth. This generates more jobs and ultimately more revenue intake from a bigger workforce. Additionally, the main mandatory spending programs, Social Security and Medicare, need some gradual changes – tax increases and modified eligibility requirements – as the baby boom generation retires. This keeps mandatory spending from consuming the federal budget and negatively affecting discretionary spending. The Department of Defense (DoD) is well aware of the impact the federal deficit has on its portion of the discretionary spending. Secretary Gates made a commitment in January 2011 to prevent growth in the defense budget over the next five years. These moves by the Secretary show that DoD understands its part in keeping spending under control; however, serious cuts in the defense budget are not advisable in order to keep the military postured to respond globally with the necessary equipment. As the national leadership makes tough fiscal choices ahead, the U.S. remains a superpower despite the country's federal debt situation.

INTRODUCTION

"I don't think it's going to happen (America's decline) provided that we deal with this debt bomb," – James Baker, Former U.S. Treasury Secretary, and U.S. Secretary of State¹

The United States (U.S.) experienced a sharp rise in federal debt the past few years. At the end of fiscal year 2008, debt held by the public (that portion of the gross federal debt held outside of the federal government, such as individuals, corporations, state and local governments, Federal Reserve System, and foreign governments) amounted to \$5.8 trillion--equal to 40 percent of the nation's annual economic output (gross domestic product, or GDP). Since then, debt held by the public went upward, surpassing \$9 trillion at the end of fiscal year 2010 – equal to 62 percent of GDP, the highest percentage since shortly after World War II.² It is clear that the current financial status of the U.S. impacts its ability to perform as a superpower both now and in the future. This paper outlines how the U.S. remains a superpower despite the country's federal debt situation.

Six sections comprise this thesis. The Background Section discusses the definitions of outlays, receipts, budget deficit, federal debt, gross domestic product (GDP), discretionary and mandatory spending, interest spending, trade deficit, and superpower. It also covers the actions of the government during the recent recession (2008-2009). Section Two addresses the U.S. maintaining status as an economic superpower. Section Three covers the U.S. decline as an economic superpower. Section Four goes over the U.S. remaining a military superpower through spending reductions. Section Five provides conclusions and recommendations.

SECTION 1: BACKGROUND

"The recent increase in debt has been the result of three sets of factors: an imbalance between federal revenues and spending that predates the recession and the recent turmoil in financial markets, sharply lower revenues and elevated spending that derive directly from those economic conditions, and the costs of various federal policies implemented in response to the conditions." –

Congressional Budget Office Report³

Every fiscal year Congress engages in the budget and appropriations process which determines the amount of government spending and revenue to collect. Outlays are the government term for spending money. Revenues are called receipts which consist of income, corporate, social insurance, excise, estate and gift, customs, and miscellaneous taxes. If the government spends (outlays) more than it takes in (receipts), then a budget deficit is incurred. Just the opposite, if receipts are higher than outlays, then the result is a surplus. In order to finance a budget deficit, the U.S. Treasury Department borrows money from individuals, other countries, and government agencies and takes on what is called federal debt.⁴

There are three categories of federal debt: debt held by the public, debt held by federal government accounts (intragovernmental), and gross (total) federal debt. Any amount of money borrowed from the public that remains outstanding is considered debt held by the public. The following is a suggestive list of lenders to the government: large financial institutions, the Federal Reserve, state or local governments, individual investors, private pension and retirement funds, insurance companies, investment funds, and foreign investors (private and government entities). Debt held by the public is most discussed because it is macro-economically significant and is sold in the credit markets.⁵

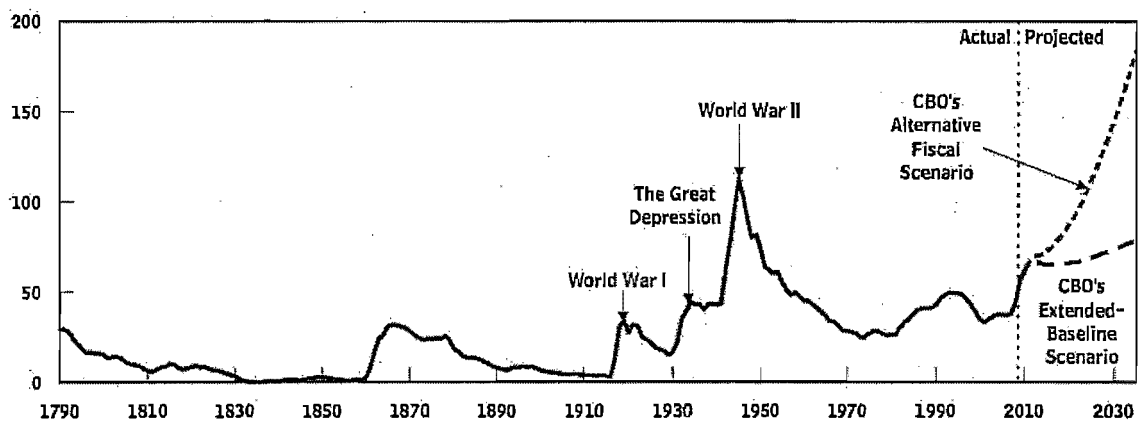
Intragovernmental debt is the amount owed by the federal government to other federal agencies and is paid out by the Department of Treasury.⁶ For example, the Social Security Administration (SSA) is required by law to invest yearly surplus funds into a government trust

fund, Social Security Trust Fund. Interest-bearing government bonds are deposited into the trust fund from the U.S. Treasury in exchange for the surplus funds. The Treasury then uses this borrowed money to fund budget requirements, thereby reducing the need for the government to borrow from the public. The trust funds hold special, nonmarketable U.S. Treasury securities that are guaranteed by the U.S. government similar to debt held by the public. “The Treasury must pay back the intragovernmental debt when an account, like the Social Security Trust Fund, needs to redeem its securities to pay expenditures exceeding its annual receipts.”⁷ Finally, gross debt is the combination of debt held by the public and intragovernmental debt.

The domestic national income is referred to as the gross domestic product (GDP) or goods and services produced within the United States in a given year.⁸ At the end of fiscal year 2010, debt held by the public surpassed \$9 trillion which was equal to 62 percent of GDP (\$14.5 trillion).⁹ See Figure 1 below for the history of this debt to GDP ratio.

Federal Debt Held by the Public, 1790 to 2035

(Percentage of gross domestic product)



Source: Congressional Budget Office, *The Long-Term Budget Outlook* (June 2010); *Historical Data on Federal Debt Held by the Public* (July 2010).

Figure 1. History of Federal Debt Held by the Public¹⁰

Spending levels (outlays), revenue collections (receipts), and economic growth (GDP) influence the movement of debt. As long as the economy outpaces debt, the debt becomes less burdensome relative to the economy as a whole.¹¹

Federal spending is divided into different categories: discretionary, mandatory and interest spending. Discretionary spending, divided into defense, domestic, and international outlays, is provided through annual appropriations acts. Defense spending composes about half of the discretionary spending (\$689 billion of \$1.367 trillion in 2010).¹² Mandatory spending, such as Social Security, Medicare, and Medicaid, is controlled by laws rather than annual appropriations acts. Net interest outlays depend on the level of borrowing and the interest rate, and ultimately these outlays represent the burden of servicing the debt.¹³

Discretionary spending accounted for 61.5% of total outlays in 1970, but only 35.2% of total outlays in 2009. Mandatory spending, by contrast, rose from 31.1% of total outlays in 1962 to 59.5% in 2009. See Table 1 below for a further breakdown of spending.

Year	Discretionary Spending	Mandatory Spending	Net Interest	Total Outlays
1970	120.3	60.9	11.4	195.6
1980	276.3	262.1	52.5	590.6
1990	500.6	568.1	184.3	1253.0
2000	614.8	951.3	222.9	1789.0
2009	1237.0	2094.0	187.3	3518.2

Table 1. Outlays for Major Categories of Spending, in Billions of Dollars¹⁴

This sharp increase of mandatory spending is largely due to the increased number of individuals now drawing Social Security, Medicare, and Medicaid benefits, as well as the extraordinary federal responses to financial turmoil in 2008-2009.¹⁵ Bottom line, as mandatory spending increases, discretionary spending as a percentage of the federal spending must be reduced.

Interest spending is a key factor when evaluating how the federal debt primarily affects the federal budget. If the government is required to pay a high amount of interest, then

budgetary flexibility is reduced because interest cannot be changed directly, unlike other federal spending. Consequently, interest spending is a function of interest rates and the amount of debt on which the government must pay interest.¹⁶ In 2010, net interest outlays totaled \$197 billion or 1.4 percent of GDP – a smaller share of GDP during most of the past 40 years (between 1.3 and 3.3 percent).¹⁷

During 2008-2009, the U.S. suffered its worst economic downturn since the 1930s which was set off by the near collapse of the U.S. financial system. As a result, global markets tumbled, several countries required bailouts to prevent defaulting on loans, and a global recession persisted. At the worst of the recession in March 2009, real GDP fell at about a 6% annual rate and monthly job losses averaged close to 750,000.¹⁸ Since then, the U.S. economy made enormous progress. Today, the financial system is operating much more normally, real GDP is advancing at a nearly 3% pace, and job growth resumed at a slow pace.¹⁹ The U.S. government's holistic response to the financial crisis included some of the most aggressive fiscal and monetary policies in history.

In 2008, the Federal Reserve responded aggressively to the financial crisis by cutting its bank lending rate to nearly zero percent, massively expanding its balance sheet in order to provide liquidity and stability to the markets, increasing its lending to depository institutions, creating new lending programs for nondepository financial institutions, purchasing mortgage-related securities, and extending support to critical financial institutions.²⁰ In addition, the Federal Reserve, as part of its monetary policy operations, announced a plan in November 2010 to purchase \$600 billion of Treasury securities. The Federal Reserve plans to sell these securities to depository institutions in order to increase the level of reserve funds in the economy, keep

down short-term interest rates, and, ultimately, influence national employment, output, and the general level of prices.²¹

Congress and the two administrations during the past decade played a significant role in all the above actions, and they also made policy decisions that affected receipt levels. Tax legislation led to dramatic changes in receipts over time from the 2001 and 2003 tax cuts, which recently got extended through 2012. Congress passed these tax cuts to spur economic growth by giving taxpayers more money to spend.²²

The monetary and fiscal actions and tax cuts mentioned above caused federal outlays to rise from 18.2% of GDP in 2000 to 24.7% of GDP in 2009 and receipts to fall from 20.6% of GDP in 2000 to 14.8% in 2009. At the same time, annual GDP growth slowed from 3.8% during surplus years (1998-2001) to 1.7% from 2002 to 2009. All the above conditions combined resulted in a rapidly growing debt held by the public.²³

Despite the rising debt, there was encouraging news. Alan Blinder and Mark Zandi used the Moody's Analytics model of the U.S. economy in July 2010 to simulate the macro-economic effects of the government's total policy response to the recession mentioned above. They found that the effects of the response on real GDP, jobs, and inflation were vast and most likely prevented another Great Depression. For example, Binder and Zandi estimate that "without the government's response, GDP in 2010 would have been about 11.5% lower, payroll employment would be less by some 8½ million jobs, and the nation would now be experiencing deflation."²⁴

Furthermore, another deficit that is important to highlight is the trade deficit – import values being greater than export values. A surplus is just the opposite with exports exceeding imports. Many believe that trade deficit is a better indicator of how well the nation's economy is performing. American businessman and investor Warren Buffett stated in the Associated Press

in 2006, "The U.S trade deficit is a bigger threat to the domestic economy than either the federal budget deficit or consumer debt and could lead to political turmoil."²⁵ Until the early 1970's, the U.S ran modest trade surpluses due to the strength of domestic companies and industrial cities. However, trade deficits emerged thereafter as globalization took over and multi-national companies, especially big financial institutions, sought wide open trade policies to gain easier access to foreign markets.²⁶ Figure 2 below gives a detailed look of the U.S. trade deficit history.

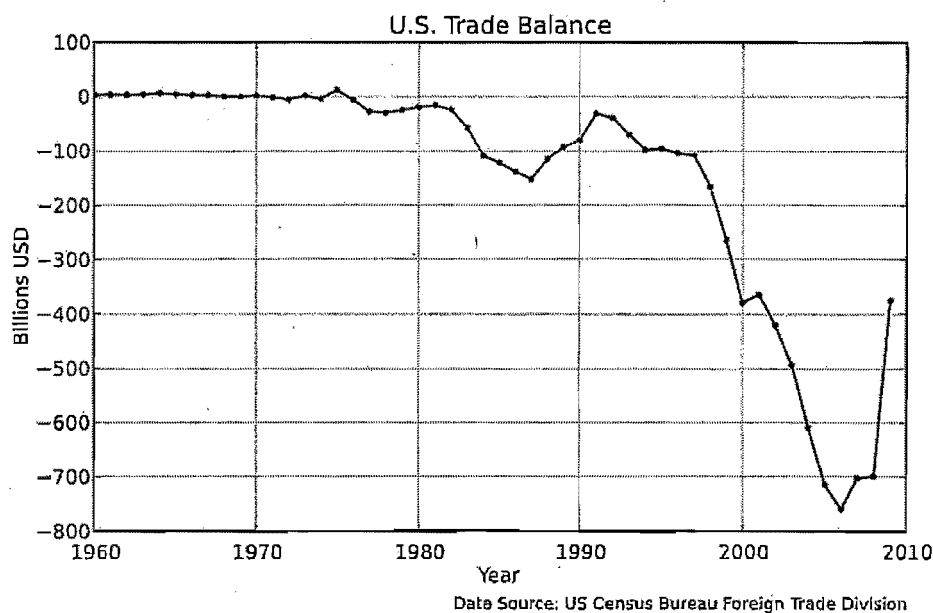


Figure 2. U.S. Trade Balance History²⁷

Before moving onto the next section of the paper, it is important that the reader understands what is meant by the term 'superpower'. Joseph Nye Jr. gives a good description of this through the use of soft and hard powers. Nye states, "Soft power is the ability to get what you want by attracting and persuading others to adopt your goals. It differs from hard power, the ability to use carrots and sticks of economic and military might to make others follow your will. Both soft and hard power are important in the war on terrorism, but attraction is much cheaper than coercion, and an asset that needs to be nourished."²⁸

When considering the possibility of influencing events worldwide, both economics and the military are used as the country's hard power capabilities. Political scientist James Kurth claims he does "not argue that economic power is *sufficient* to account for supremacy in world affairs, only that it is *necessary*."²⁹ Another important aspect to maintaining superpower status is the country's soft power capabilities carried out by the interagency and non-governmental organizations. These soft powers are not covered in this thesis; rather a focus is placed on hard power. The reason to hone in on the military is because the U.S. economic situation puts in jeopardy discretionary spending, and the U.S. defense budget makes up the predominance of this type of spending.

SECTION 2: MAINTAINING STATUS AS AN ECONOMIC SUPERPOWER

"If you fail to rein in entitlements and other federal spending, you will either have to raise taxes, squeeze out military and other discretionary spending, or pile up the debt on future generations." – G. Tracy Mehan, III, *The American Spectator*³⁰

"Our financial health is directly related to our national security. The biggest driver globally right now is the economy -- and I'd argue it always has been. I'm not an economist and I'm not a finance guy, but I need to understand the global trends that work those engines."
– Admiral Mike Mullen, Chairman of Joint Chiefs of Staff³¹

The mounting expenses of servicing the growing national debt, skyrocketing costs of mandatory program spending for Social Security, Medicare, and Medicaid, recession spending, reduced revenues, and the trade deficit are all reasons for the growing federal debt. This leaves less money for initiatives at home and abroad and ultimately weakens public support for the expansive international role that the United States assumed since the end of World War II.³² Each of the above economic areas is covered in detail in the following paragraphs.

First, expenses on servicing the national debt, or interest spending, is of concern because these outlays affect the amount of flexibility the government has to spend money. By law, the government must fund interest on its debt and mandatory spending programs first. As a result,

less cash is available for discretionary programs such as national defense. During the recent recession, the Federal Reserve kept interest rates on Treasury securities near the lowest levels ever on record.³³ This resulted in some of the lowest interest outlays compared to percentage of the GDP over the last forty years. Many investors, especially foreign, still consider U.S. Treasuries to be an attractive investment due in part to being essentially free of any risk of default. At the end of 2010, foreign entities owned about 47 percent of the debt held by the public.³⁴ See Table 2 below for a list of the top five major foreign holders of Treasury securities and the overall grand total for all foreign holders (in billions of dollars).

Country	Oct 2010	Oct 2009
China	906.8	938.3
Japan	877.4	742.9
United Kingdom	477.6	108.1
Oil Exporters	213.9	209.0
Brazil	177.6	164.9
Overall Grand Total	4310.2	3576.1

Table 2. Top Five Major Foreign Holders of Treasury Securities and Overall Grand Total³⁵

If the U.S. enacts policy to keep the federal debt from rising out of control, investor confidence remains strong allowing interest rates to remain relatively low. However, the moment the world sees a ‘kink in the armor’ of the U.S., interest rates rise as investors’ confidence declines.³⁶

Second, three mandatory spending programs, Social Security, Medicare, and Medicaid, are of vital interest to the long term health of the U.S. economy. Passed in 1935, the Social Security Act allowed taxes to first be first collected in 1937.³⁷ The Social Security Act Amendments of 1965 created the two health benefit programs, Medicare and Medicaid. Medicare is health insurance for people 65 or older and under 65 with certain disabilities; and Medicaid is a joint federal-state health-financing program for low-income individuals. The costs of these programs are expected to skyrocket as the approximately 76 million-strong baby boom

generation (1946-1964) retires this decade.³⁸ Since Medicaid is a federal-state program and every state handles Medicaid differently, this program is not elaborated on in this paper.

The Medicare program consists of two components: Hospital Insurance (HI), or Medicare Part A, which helps pay for hospital and home health care, and Supplementary Medical Insurance (SMI) which consists of Medicare Part B and Part D. Part B helps pay for physician and outpatient services for the aged and disabled who have voluntarily enrolled; and Part D provides subsidized access to drug insurance coverage on a voluntary basis. Total Medicare benefits paid in 2009 were \$502 billion; total expenditures were \$509 billion; income was \$508 billion; and assets held in special issue U.S. Treasury securities were \$381 billion (HI and SMI Trust Funds). The Affordable Care Act passed in March 2010 introduced important changes to the Medicare program that are designed to reduce costs, increase revenues, and expand the scope of benefits.³⁹ As a result, the financial future of the program looks more upbeat than in years past. However, the retirement of the baby boom generation over the next few decades brings more individuals into the Medicare program depleting the surplus in the trust funds. One response to this is to raise premiums for SMI coverage and increase the payroll tax rate (currently 1.45% for employees) to cover HI costs. The end state is to balance receipts and outlays to keep the program running without significant impact.

Social Security taxes are paid by the employee and employer. These taxes are considered 'Social Security receipts'; and the outlays are those funds distributed to program eligible individuals. Receipts outpaced outlays since 1981 creating a large surplus of over \$2.5 trillion.⁴⁰ By law, surplus funds are invested into U.S. Government securities and held in a Social Security Trust Fund run by the U.S. Treasury. The surplus funds are used for whatever present purposes the government requires.⁴¹ Furthermore, the Congressional Budget Office (CBO) estimates the

Social Security program runs a cash deficit for the first time in 30 years during 2010, but a surplus returns with an improved economy and higher employment levels.⁴² Overall, the strong surplus creates a rather promising outlook on Social Security; however, the baby boom generation retirement likely causes the Social Security Trust Fund to be depleted. As in years past, this is going to require the current and future administrations to make policy changes to increase tax rates and change eligibility requirements. The end goal keeps a close balance between outlays and receipts each year since the government is required to borrow more money as the Social Security Trust Fund cashes in securities to pay the outlays that receipts do not cover.

Third, Congress and the Federal Reserve made many bold and decisive spending decisions during the 2008-2009 recession. These moves resulted in the Federal Reserve buying \$1.4 trillion of mortgage-backed securities and mortgage debt, as well as up to \$300 billion worth of government debt.⁴³ Before the financial crisis began in July 2007, the Federal Reserve held about \$900 billion in assets. By the end of 2010, the value of the Fed's assets grew to about \$2.4 trillion (see Appendix A for a further breakdown). The major items on the liability side of the Federal Reserve balance sheet are Federal Reserve notes (U.S. paper currency) and the deposits that depository institutions hold in accounts at the Federal Reserve Banks, which grew from about \$6 billion at the end of July 2007 to more than \$1 trillion at the end of 2009 (see Appendix A for a detailed breakdown).

The Federal Reserve's holdings affect the remittances to the U.S. Treasury, which are recorded as revenue (positive or negative) and used in the federal budget each year.⁴⁴ The Federal Reserve paid a record \$78.4 billion in earnings to the U.S. Treasury in 2010, which is the largest ever paid by the bank since inception in 1914 and surpasses last year's record of \$47.4

billion.⁴⁵ This is a positive sign that the investments made by the Federal Reserve during the 2008-2009 recession assisted in stabilizing the economy, and that money is being recouped.

Fourth, reduced revenue (receipts) is a major factor in determining whether a budget deficit or surplus is attained and if the country needs to borrow money to cover a deficit. Federal receipts in large part are more abundant during periods of a strong economy, where collections through income, corporate, and capital gains taxes are stronger. Conversely, a slow economy results in less income for individuals, and corporations experience a decline in profits which brings in fewer receipts to the federal government.⁴⁶ As seen in Figure 2 below, receipts hovered around 15% compared to GDP in 2009 and 2010, down considerably from prior years which averaged around 18%. This is a result of many workers being unemployed, and much capacity (such as equipment and buildings) being unused. In addition to unemployment causing low tax receipts, Congress passed legislation in December 2010 that continued the 2001 and 2003 tax cuts for two more years, keeping tax rates on all income levels from being raised. The tax bill also reduced the Social Security payroll tax during 2011 by two percentage points for employees.⁴⁷ These tax policies cost the government around \$320 billion in revenue in 2011 and 2012, which certainly do not help in reducing the budget deficit.⁴⁸ However, consumer paychecks are larger from these tax breaks, leading to increased spending on goods and services. Ultimately, this leads to an economic rebound and a lower unemployment rate that results in more federal revenues from an increased work force.⁴⁹

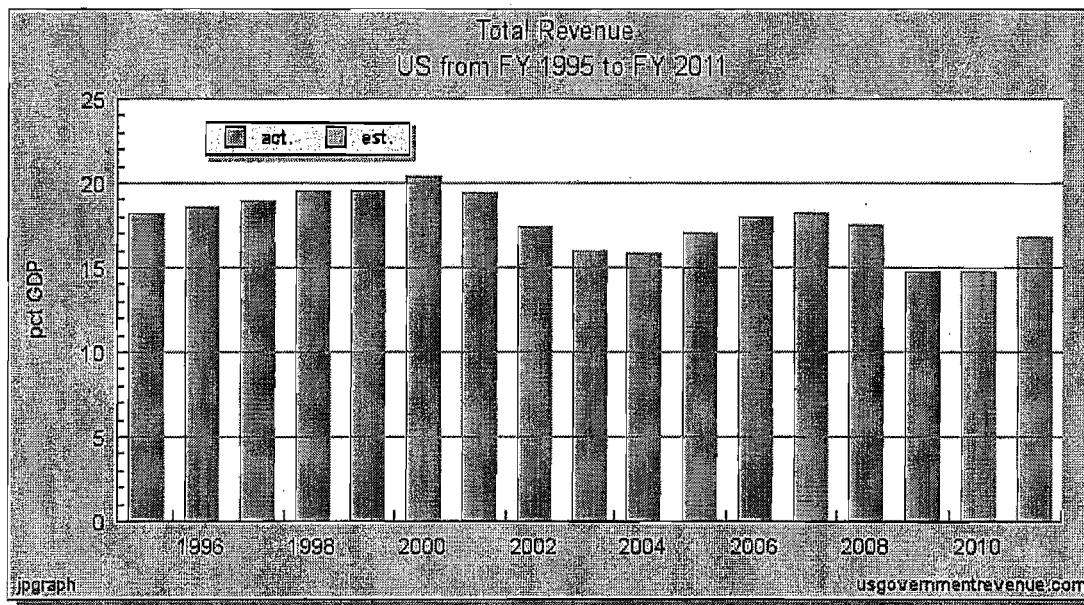


Figure 3. Historical Revenues to Percentage of GDP⁵⁰

Fifth, the U.S. trade deficit for 2010 amounted to \$497.8 billion, surging 32.8 percent from the previous year. This amount resulted in the biggest annual percentage gain since 2000, causing overall economic growth to be cut one-half percentage point.⁵¹ However, many private economists predict that gains in exports will offset increased imports in 2011, causing the trade deficit to be less of a drag on the economy. Zandi states, "American companies are very competitive right now, especially with a weaker dollar. They are poised to enjoy strong global growth in coming years."⁵² President Obama set a goal of doubling the nation's exports in five years in order to attack high unemployment rates.⁵³

China made up more than half of the trade deficit for 2010 (\$273.1 billion),⁵⁴ the largest imbalance the U.S. ever recorded with a single country.⁵⁵ China is now the largest exporter and soon to be the largest manufacturer in the world surpassing the U.S. in the next five to seven years.⁵⁶ Much of the manufacturing sector of the U.S. went offshore to China (and other countries, notably India) resulting in a drop of U.S. manufacturing from 25% of GDP in 2005 to 13% in 2009.⁵⁷ If more jobs are sent overseas and less manufacturing is done in the U.S., the

unemployment rate struggles to return to pre-recession numbers (4-5%). Scott Paul, executive director of the Alliance for American Manufacturing, best summarizes this topic, "It will be hard to get our unemployment rate down if our trade deficit keeps going up."⁵⁸

Additionally, the U.S. dollar is the world trade and reserve currency. As of March 2009, 65 percent of the world's \$6.8 trillion of foreign reserves is held in dollars.⁵⁹ However, China, who holds 30 percent of the world reserve, believes that the weakened dollar should be replaced by another global currency for international trade.⁶⁰ They proposed in 2009 for a "super-sovereign reserve currency" under International Monetary Fund (IMF) management, turning the Fund into a sort of world central bank.⁶¹ Due to China's world reserve holdings, they now have a say in the world currency matter. President Obama stated his confidence in the U.S. dollar, "I don't believe that there is a need for a global currency. The reason the dollar is strong right now is because investors consider the United States the strongest economy in the world with the most stable political system in the world."⁶² The U.S. dollar remaining as the world trade and reserve currency is crucial for the U.S. economy and thus the world economy. As President Obama stated, investor confidence in the U.S. is essential and that confidence is obtained through reduction in federal debt.

Section Two of this paper showed that expenses for servicing the national debt, mandatory programs, and the 2008-2009 recession, coupled with reduced revenues, all point to a widening budget deficit. Nevertheless, policies put in place by the Federal Reserve and decisions made by Congress over the last two years stabilized the economy and created growth. Reducing the trade deficit is also a major factor in growing the economy, creating jobs, and diminishing the federal debt. Many new decisions lie ahead for the Administration, Congress,

and the Federal Reserve to control the federal debt and maintain a strong worldwide economic presence.

SECTION 3: THE DECLINE OF AN ECONOMIC SUPERPOWER

*"Most imperial falls are associated with fiscal crises. Past empire falls were marked by sharp imbalances between revenues and expenditures, as well as difficulties with financing public debt."*⁶³ – Niall Ferguson, Professor of History at Harvard University

Many economists and theorists believe that the decline of the U.S as an economic superpower is ongoing for many reasons. First, comparing the U.S. as a great power with that of earlier empires in relation to interest spending is prudent. By no means is the U.S. an empire, but as a great power with both soft and hard power capabilities to persuade and coerce other nations, the U.S. is on par with past empires. The Spanish Empire defaulted on all or part of its debt 14 times between 1557 and 1696; the French Empire spent 62 percent of royal revenue on debt service by 1788; the Ottoman Empire went the same way with interest payments rising from 15 percent of the budget in 1860 to 50 percent in 1875; and the British Empire interest payments equaled 44 percent of the British budget between the interwar years in the 20th century.⁶⁴ Each of the above empires rose and fell in a pattern of conquest, innovation, sea power, and then ended by trying to survive on accumulated wealth with a lack of real productive activities.⁶⁵

The U.S. is certainly headed down the above direction in regards to higher interest spending and reduced manufacturing, but one major difference between the U.S. and past empires is that the U.S. is not responsible to maintain colonies. The past empires possessed colonies across vast areas and invested money into them to maintain the colony. When economic conditions declined in the homeland, borrowing money proved to be the only option available. Eventually, this accrued debt caught up with the empires and economic conditions assisted in their collapse. The U.S. possesses territory outside the U.S. but there is no

requirement to commit large resources for them. The U.S. focuses on making decisions for the homeland and when necessary to support global crisis and operations.

Over the course of the last decade, several countries faced rising interest rates over a short period of time causing major economic changes to be enacted. Argentina's fortunes changed quickly during a recession in 2000-2001, investors demanded a higher interest rate (5 percentage points) for holding government debt. Ireland's debt and interest payments grew very rapidly in 2008-2009, and investors in 10-year Irish bonds demanded almost 3 percentage points in extra annual interest relative to the rate for German bonds of the same maturity. Greece also suffered during the recent global recession with a huge debt equal to 110 percent of the country's GDP. By January 2010, Greece paid an interest rate on 10-year bonds that was 4 percentage points higher than Germany paid. In all the above fiscal crises, consumer confidence in the government's ability to pay interest on its debt eroded causing sharp increases in interest rates. This lack of confidence forced the affected governments to make difficult spending and revenue choices to ensure the government did not default on its debt.⁶⁶

Next, the U.S. faced a similar situation as described above in the 1980s and into the 1990s when debt held by the public as a percentage of GDP continuously rose to levels beyond the Great Depression of the 1930s. As the country continued to borrow to finance the debt, higher interest costs resulted in higher outlays, which rose from 1.9% of GDP in 1980 to 3.1% in 1989. The following reasons caused these higher interest costs: policy choices to increase defense spending, reduced revenues through significant tax cuts, and a slow economy.⁶⁷ In 2011, defense spending remains high due to the wars in Iraq and Afghanistan; revenues are being reduced as the country emerges from the recent recession, and the persistent unemployment rate is negatively affecting a full economic recovery. The 1980s and 2010s look very similar when

evaluating economic conditions. With budget deficits looming for the foreseeable future, the U.S. Treasury is required to borrow massive amounts of money. It is paramount that the U.S. maintains low interest rates and keeps consumer confidence high to avoid situations that Argentina, Ireland, and Greece encountered.

When private investors begin to doubt the federal government's ability to meet interest payments, they experience reluctance or unwillingness to invest in government securities. As of the second quarter of 2009, American households sold Treasuries on a massive scale and mutual funds purchased Treasuries on a modest level (\$142 billion). United States banks maintained asset allocation for government bonds at about 13 percent, relatively low by historical standards. That left two potential buyers: the Federal Reserve and foreigners, who both bought large amounts of securities in the second quarter of 2009.⁶⁸

When the Federal Reserve buys securities (or prints money), the stocks of reserve to commercial banks and the amount of money in circulation both increase. These actions lead to rapidly accelerating inflation if not carefully enacted.⁶⁹ Inflation causes the value of the dollar to weaken, which leads foreign investors to ask for a higher nominal rate on U.S. Treasuries to compensate for the weakened dollar.⁷⁰ Economists largely agreed inflation bottomed out during 2010. They also said the increase of the Consumer Price Index (CPI) by 0.2 percent in January 2011, the largest increase since October 2009, was unlikely to trouble policymakers at the Federal Reserve, who continue to buy securities and pump money into the economy. Stuart Hoffman, chief economist at PNC Financial in Pittsburgh, sums up this topic by stating, "Inflation has bottomed out, that's actually what the Fed would like to see happen and these numbers (CPI) are by no means alarming."⁷¹

Rising interest rates on debt in other countries and that of the U.S. in the 1980s and 1990s are good examples to compare against the current U.S. economic situation. Despite there being no way to predict the threshold at which debt or interest spending becomes unsustainable, the current debt held by the public to GDP ratio and the Federal Reserve's efforts to maintain low interest rates both show the U.S. maintains economic stability for the near term. Table 1 below shows that the U.S. remains well below other countries' debt to GDP ratio.

U.S.	83.9%
Portugal	83.8%
Belgium	101.2%
Greece	114.9%
Iceland	117.6%
Italy	123.6%
Japan	189.3%

Table 3. Gross debt of countries in 2009 as a percentage of GDP⁷²

Finally, regardless of the near term outlook of stability described above, Niall Ferguson believes "complex systems are made up of a very large number of interacting components that are asymmetrically organized. They operate somewhere between order and disorder—on the edge of chaos. Empires behave like all complex systems. They function in apparent equilibrium for some unknowable period and then, quite abruptly, they collapse."⁷³ Ferguson points out that a relatively minor shock causes disproportionate disruptions, such as the subprime mortgage crises that spurred the near collapse of the U.S. financial system in 2008-2009 and threatened the collapse of international trade.⁷⁴ He does admit though, that future debt numbers cannot erode U.S. strength on their own; however, one day a piece of bad news brings about serious ramifications and causes investors, both domestic and foreign, to worry about the U.S. fiscal policy.⁷⁵

Section Three discussed the potential decline of the U.S as an economic superpower. Comparisons to past empires and other countries that experienced recent economic trouble proved to be valuable. Furthermore, higher interest rates, reduced private investments, and the Federal Reserve printing more money cause inflation and a weakened dollar. Finally, Niall Ferguson's belief that the U.S. is complex system operating on the edge of chaos and susceptible to abrupt collapse showed that the U.S. remains vulnerable.

SECTION 4: REMAINING A MILITARY SUPERPOWER THROUGH SPENDING REDUCTIONS

Linking the spending and revenue factors in section two to the military's ability to respond to worldwide crisis is vital when evaluating the U.S. as a superpower. More and more demands for U.S. security services are surfacing throughout the world requiring the U.S. to study the situation carefully and develop a comprehensive strategy. The core of the problem is the growing connection between the global economy and security policy, including defense strategy.⁷⁶ In a recent speech by Secretary of Defense Robert Gates, he mentioned how there have been calls from "various quarters for major reductions in defense spending – to include substantial cuts in modernization, force structure, troop levels and overseas bases. I consider such proposals risky at best and potentially calamitous."

Mandatory programs and interest spending shape the amount of funds available for discretionary spending, which includes the defense budget. In 2010, total discretionary spending fell to 9.3% of GDP with defense spending totaling 4.7% of GDP. See Appendix B for a history of discretionary spending and for the breakdown of defense and non-defense spending within the discretionary total. Military spending increased sharply over the last decade. On average, from 2000 to 2010, defense outlays grew 6.8% per year in real terms.⁷⁷ The U.S. defense spending is still relatively low when compared to the time period from 1950-1990 (Cold War era) but it is

high compared to the Western Europeans. Only France and the U.K. spend more than 2% of GDP on defense, supposedly the NATO-mandated minimum, and nearly every other country is below that. Germany, the continent's largest economy, stands at 1.3% of their GDP.

A valid question is whether the U.S. eventually arrives at the same position as the Europeans given current economic conditions outlined in this paper. One very important commitment laid out by Secretary Gates in his speech on January 7, 2011 identified the Department of Defense's way ahead with spending cuts and means to maintain the force at the appropriate levels. The latest budget proposal anticipates a total reduction of roughly \$78 billion to the Five Year Defense Plan submitted last year, \$100 billion in savings across the services but reinvested back into the services, a reduction in real growth in the department's top line in FY 2013 and in FY 2014, and then zero real growth in FY 2015 and 2016.⁷⁸

Secretary Gates made a commitment to reduce growth in defense spending and stabilize the defense budget; however, he did emphasize that the cuts were small enough to keep the military force prepared to respond to worldwide crisis and not seriously degrade any future capability. The Secretary understands the link between economics, military power, and our status in the world. He stated, "This country's dire fiscal situation – and the threat it poses to America influence and credibility around the world – will only get worse unless the U.S. Government gets its finances in order. And as the biggest part of the discretionary federal budget the Pentagon cannot presume to exempt itself from the scrutiny and pressure faced by the rest of our government."⁷⁹

Personnel reductions are a major part of the plan to keep the budget flat in FY 2015 and FY 2016. More than \$6 billion is expected to be saved from reducing the size of the Active Army and Marine Corps. Under the plan outlined by the Secretary, the Army's permanent active

duty end strength declines by 27,000 troops, while the Marine Corps declines by somewhere between 15,000-20,000 Marines. These reductions are based on the U.S. ground combat commitment in Afghanistan being significantly reduced by the end of 2014 in accordance with the President's strategy.⁸⁰ This rollback of numbers puts the services back at pre-2009 personnel levels. With operations also winding down in Iraq and the expected drawdown in Afghanistan, these cuts are not expected to negatively affect the U.S. military in accomplishing operations worldwide nor put any undue stress on the force as a whole.

The major acquisition program that the Secretary of Defense recently announced to be cancelled is the Expeditionary Fighting Vehicle (EFV). The EFV, originally envisioned in the 1980s, consumed more than \$3 billion to date for development and costs another \$12 billion to build. If fully executed, the EFV swallows the entire Marine Corps vehicle budget and most of its total procurement budget for the foreseeable future.⁸¹ The more fiscally responsible decision is to upgrade the existing amphibious assault vehicle (AAV) fleet until a more cost effective AAV is developed. When evaluating the impact of this decision by the Secretary, the characteristics of the EFV, most notably getting discharged from naval shipping 25 nautical miles offshore, are not necessary in the future. General Joseph Dunford, the Corps' assistant commandant commented on the ship-to-shore requirement for Marines, "We think it is somewhere in excess of 12 nautical miles but something less than 25 nautical miles."⁸² The upgraded AAV or future AAV, along with airborne capabilities, is sufficient to meet this ship-to-shore requirement.

The planned reductions over the next five years are enough to reduce real growth in defense spending and still allow the U.S. to respond to the complex and unpredictable array of security challenges around the globe (global terrorist networks, rising military powers, nuclear

armed rogue states). Major reductions in military spending are risky and at this point in the nation's history lead to tragic consequences later. The U.S. remains the backer of security for most of the free world because of the reach and unquestioned superiority of its military. "The benefits – in terms of stability, prosperity, and the steady expansion of political freedom and economic growth – have accrued not only to our allies and partners, but above all, to the American people," said Secretary Gates.⁸³

SECTION 5: CONCLUSIONS AND RECOMMENDATIONS

"Governments now face a tricky period when they have to deal with the debt overhang, decide how quickly to cut the deficit (and risk undermining growth), and try to distribute the pain of doing so as equitably as possible." – The Economist⁸⁴

The hard power capabilities of the U.S., economics and military, are essential for the U.S. to remain a superpower. The country's soft powers, such as diplomacy, are also critical but these are not covered in this thesis. During the first decade of the 21st century, the U.S. responded to numerous international crises, encouraged globalization, and helped build a thriving global economy. The 2008-2009 recession put the world on alert as the U.S. financial system nearly collapsed. As a result, the Administration, Congress, and the Federal Reserve responded with massive fiscal and monetary policies that stabilized the U.S. economy and brought calm to the world market. As the country comes out of the recession and the economy begins to grow again, spending needs to be reined in. The Administration and Congress are beginning to negotiate this reduced spending with the 2012 and beyond federal budgets.

Next, the country needs to keep interest outlays below 2% of GDP and revenue intake around the historical normal of 18% of GDP. Tax breaks put into law in 2010 put more money in taxpayer's pockets, and the Administration is relying upon these taxpayers to spur economic growth through increased spending. This generates more jobs and ultimately more revenue

intake from a bigger workforce. Additionally, the main mandatory spending programs, Social Security and Medicare, need some gradual changes – tax increases and modified eligibility requirements – as the baby boom generation retires. This keeps mandatory spending from consuming the federal budget and negatively affecting discretionary spending. The DoD is well aware of the impact the federal deficit has on its portion of the discretionary spending. Secretary Gates made a commitment in January 2011 to prevent growth in the defense budget over the next five years. These moves by the Secretary show that DoD understands its part in keeping spending under control; however, serious cuts in the defense budget are not advisable in order to keep the military postured to respond globally with the necessary equipment.

In conclusion, as national leadership makes tough fiscal choices ahead, the U.S. remains a superpower despite the country's federal debt situation. Paul Kennedy in the *The Rise and Fall of Great Powers* sums up what is needed, "The very unstructured, laissez-faire nature of American society (while not without its weaknesses) probably gives it a better chance of readjusting to changing circumstances than a rigid power would have. But that in turn depends upon the existence of a national leadership which can understand the larger processes at work in the world today."⁸⁵

ENDNOTES

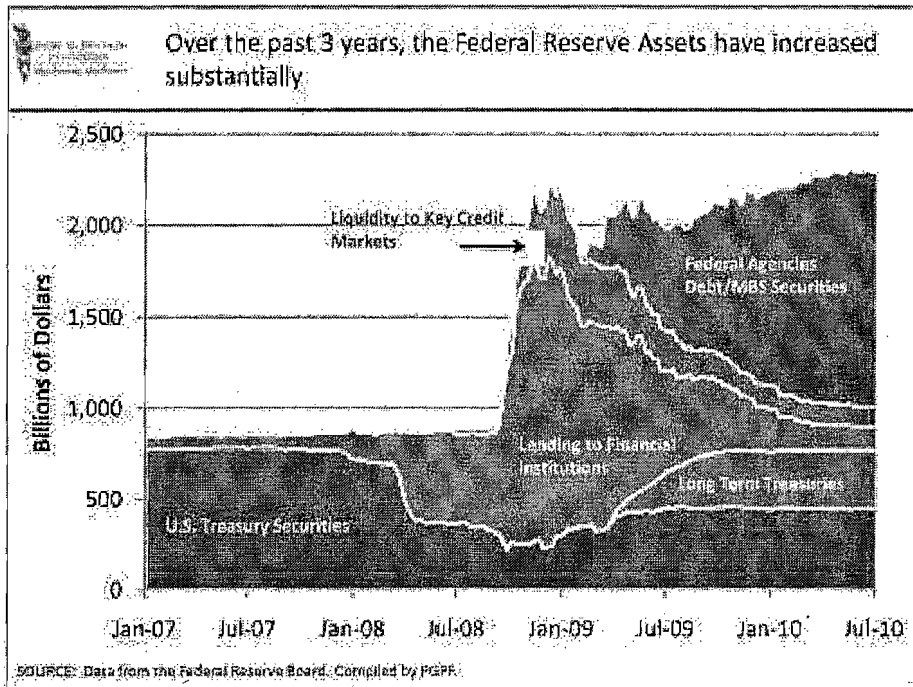
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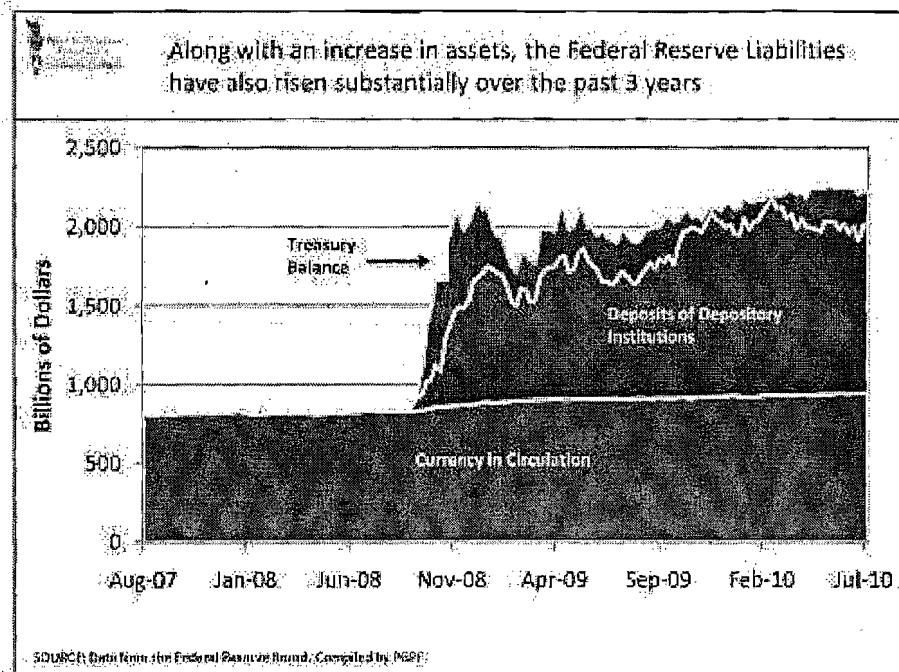
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- ⁸⁵ Paul Kennedy, *The Rise and fall of the Great Powers* (Vintage Books, New York, New York, 1987), 514.

APPENDIX A: HISTORICAL ASSETS AND LIABILITIES OF THE FEDERAL RESERVE

<http://www.pgpf.org/Issues/Fiscal-Outlook/2010/08/11/Analyzing-the-Budgetary-Impact-Federal-Reserve.aspx>
(accessed January 10, 2011)



ASSETS



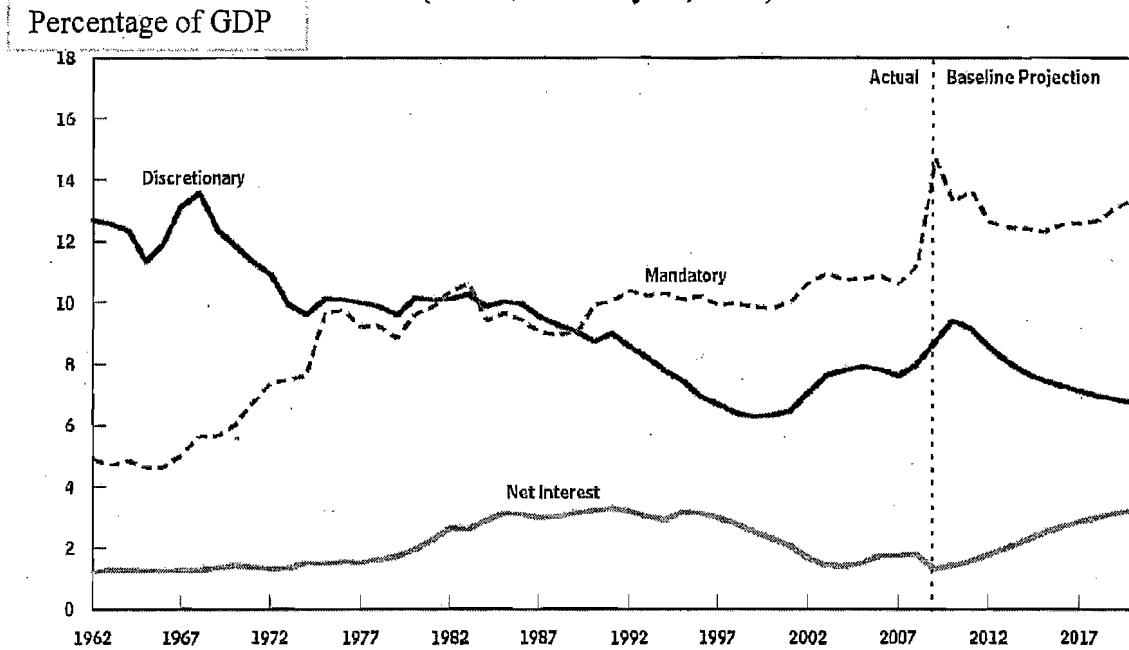
LIABILITIES

APPENDIX B: OUTLAYS BY CATEGORY

from the CBO website

<http://www.cbo.gov/ftpdocs/106xx/doc10621/DiscretionarySpending05-05.pdf>

(accessed January 12, 2011)

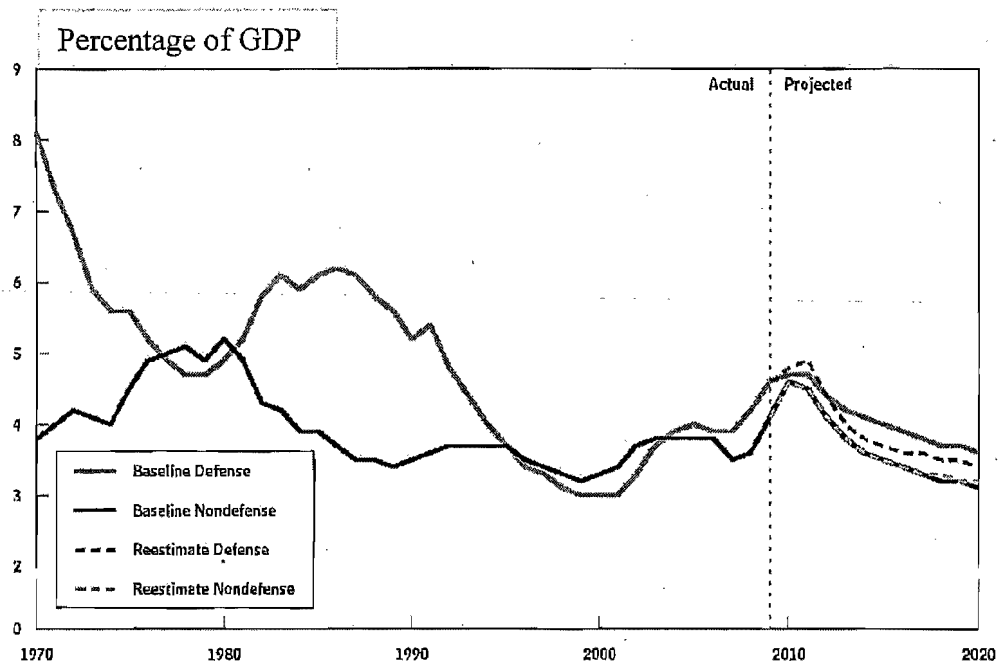


DISCRETIONARY OUTLAYS FOR DEFENSE AND NONDEFENSE SPENDING

from the CBO website

<http://www.cbo.gov/ftpdocs/106xx/doc10621/DiscretionarySpending05-05.pdf>

(accessed January 12, 2011)



APPENDIX C: DEFINITIONS

from U.S. Government Accountability Office (GAO) website
<http://www.gao.gov/new.items/d05734sp.pdf> (accessed January 9, 2011)

Receipts – Collections from the public based on the government’s exercise of its sovereign powers, including individual and corporate income taxes and social insurance taxes, excise taxes, duties, court fines, compulsory licenses, and deposits of earnings by the Federal Reserve System.

Outlays – The issuance of checks, disbursement of cash, or electronic transfer of funds made to liquidate a federal obligation. Outlays also occur when interest on the Treasury debt held by the public accrues and when the government issues bonds, notes, debentures, monetary credits, or other cash-equivalent instruments in order to liquidate obligations.

Budget – A detailed statement of anticipated revenues and expenditures during an accounting period. For the federal government, the term “budget” often refers to the President’s budget submission to Congress early each calendar year in accordance with the Budget and Accounting Act of 1921, as amended, and represents proposals for congressional consideration.

Unified Budget – Under budget concepts set forth in the *Report of the President’s Commission on Budget Concepts*, a comprehensive budget in which receipts and outlays from federal and trust funds are consolidated. When these fund groups are consolidated to display budget totals, transactions that are outlays of one fund group for payment to the other fund group (that is, interfund transactions) are deducted to avoid double counting.

Federal Funds – Budgetary accounts composed of moneys collected and spent by the federal government other than those designated as trust funds. Federal fund accounts include general, special, public enterprise, and intragovernmental fund accounts.

Trust funds – Represent one accounting mechanism used to link earmarked receipts with the expenditures of those receipts. The Office of Management and Budget (OMB) and the Department of the Treasury determine budgetary designation as a trust fund when a law both earmarks receipts to a program and identifies the account as a “trust fund” account.

Off-Budget – Those budgetary accounts (either federal or trust funds) designated by law as excluded from budget totals.

On-Budget – All budgetary accounts other than those designated by law as off-budget.

Budget Deficit – The amount by which the government’s budget outlays exceed its budget receipts for a given period, usually a fiscal year.

Budget Surplus – The amount by which the government’s budget receipts exceed its budget outlays for a given period, usually a fiscal year.

Federal Debt – The amount borrowed by the government from the public or from government accounts. Four ways that federal debt may be categorized for reporting purposes are (1) gross

federal debt, (2) debt held by the public, (3) debt held by government accounts, and (4) debt subject to statutory debt limit.

Debt Held by the Public – That portion of the gross federal debt held outside of the federal government. This includes any federal debt held by individuals, corporations, state or local governments, the Federal Reserve System, and foreign governments and central banks.

Debt Held by Government Accounts (Intragovernmental Debt) – Federal debt owed by the federal government to itself. Most of this debt is held by trust funds, such as Social Security and Medicare. The Office of Management and Budget (OMB) contrasts it to debt held by the public by noting that it is not a current transaction of the government with the public.

Gross Federal Debt – Gross federal debt is the sum of debt held by the public and debt held by government accounts (intragovernmental debt).

Debt Subject to Statutory Debt Limit – Debt guaranteed as to principal and interest by the United States.

GDP (Gross Domestic Product) – The value of all final goods and services produced within the borders of a country such as the United States in a given period, whether produced by residents or nonresidents. The components of GDP are personal consumption expenditures, gross private domestic investment, net exports of goods and services, and government consumption expenditures and gross investment.

Discretionary Spending – Refers to outlays from budget authority that is provided in and controlled by appropriation acts. “Discretionary appropriation” refers to those budgetary resources that are provided in appropriation acts, other than those that fund mandatory programs.

Mandatory Spending – Refers to budget authority that is provided in laws other than appropriation acts and the outlays that result from such budget authority. Mandatory spending includes entitlement authority (for example, the Food Stamp, Medicare, and veterans’ pension programs), payment of interest on the public debt, and nonentitlements such as payments to states from Forest Service receipts.

Treasury Security – A debt instrument of the U.S. Treasury issued to finance the operations of the government or refinance the government’s debt.

Treasury Bill – The shortest term federal debt instrument or security. Treasury bills mature within 1 year after the date of issue.

Treasury Bond – A federal debt instrument with a maturity of more than 10 years.

Treasury Note – A federal debt instrument with a maturity of at least 1 year but not more than 10 years.

Unemployment Rate – As defined by the Bureau of Labor Statistics (BLS), the number of people who do not have jobs but have actively looked for work in the prior 4 weeks and are currently available for work, expressed as a percentage of the civilian labor force.

Deflation – A sustained decrease in the general price level.

Inflation – A rise in the general price level.

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